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SPECIAL ISSUE

THE 1988 INVESTOR'S GUIDE

FEATURING THE FORTUNE INVESTMENT CHALLENGE

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FORTUNE

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"I should probably diversify more, but I believe in my company."

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"Texaco is as solvent as anything for the senior bondholders, even if Pennzoil gets its \$10 billion."

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If you are not ready to retire and your children are young, set up a testamentary trust funded with your common stock with your children as beneficiaries.

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His picks were so prescient that all he did for most of the year was sit and smile.

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"Last year's gains were just so great they can't be repeated. I think if the market is up 10% over the next 12 months, we'll be in good shape."

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"It sounds obvious, but what do movie actors and ballplayers know about running car washes and restaurants? Usually nothing."

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THE EDITOR'S DESK



Guiding the Guide: front, editor Johnson flanked by William Bowen and Edmund Faltermayer; rear, Terence Paré, John Curran

WELCOME to FORTUNE's third annual Investor's Guide. It's a special issue full of immediately useful advice about where to put your money now—and what strategies appear most sensible for the longer term. Much has been written on these subjects, of course, but we believe that FORTUNE brings to them a depth of experience that you will find unique—and valuable.

The Guide has been created by 30 members of FORTUNE's staff, ranging from the market watchers who regularly produce our biweekly Personal Investing section to the economists who develop the FORTUNE Forecast. Editor Keith Johnson has been supervising the project for three months. In fact, he has been in charge of all three of our annual guides and found this one the toughest challenge yet. It's not easy to discover investments that seem safe yet attractive after the stock market's sharp rise of the past two years. But, says Johnson, "I was pleasantly surprised at how many op-

portunities are still out there despite the run-up in stock prices."

Johnson was assisted by Edmund Faltermayer, who edits Personal Investing, and William Bowen, a longtime assistant managing editor who came out of retirement to wield his graceful pencil. Our lead investment writer, John Curran, produced three of the stories in the Guide, including those on wise strategies for investing in stocks, bonds, and real estate over the next year. "We go beyond the basics, the nuts and bolts," he says. "We want investors to understand the engines that drive today's sophisticated investment vehicles." Reporter Andrew Serwer examined the usefulness of studying return on equity, a measure of basic profitability that he says should be the starting point for picking an investment. And reporter Joshua Mendes interviewed stock analysts in six countries to uncover some promising stocks overseas. (This is the first of the Guides

to be distributed in Europe and in Asia.)

For the essential background that every investor needs, our chief economist, Todd May, using FORTUNE's own computerized model, forecasts the direction of the U.S. economy from now through the end of 1988. Writer Robert Norton tells investors of the opportunities and pitfalls presented by the new tax law. And for the second year running, reporter Terence Paré handled the computer program that tracks the FORTUNE Investment Challenge, in which six top money managers compete to create your best investment portfolio. The competition for 1987 produced a surprise: Two professionals with entirely different strategies virtually tied for first place. Their investment choices—and impressive gains—are revealed on page 176.

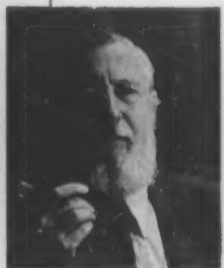
Reporters Leslie Brody and Kelly Tasker wrangled with the intricacies of such exotica as real estate investment trusts and computer networking stocks. Joan Hoffman



Renee Klein, Joan Hoffman, Eric Godwin

designed the issue, aided by associate art director Renee Klein, who created many of the stylish illustrations, and assistant picture editor Eric Godwin. Godwin displayed ingenuity and doggedness in projects that included photographing the financial advisers to such well-rewarded celebrities as Madonna and Joan Collins.

Bartholomew Lee
MANAGING EDITOR



Chief economist Todd May, Robert Norton, Andrew Serwer, and Joshua Mendes

FORTUNE (ISSN 0015-8259) Published biweekly, with three issues in October, by Time Inc. Time Inc. principal office: Time & Life Building, Rockefeller Center, New York, NY 10020-1393. N. J. Nicholas Jr., President; Glenn A. Britt, Treasurer; William M. Gutman, Secretary. Subscriptions: U.S. possessions, one year \$44.50, Canada one year \$56. Address correspondence concerning subscriptions to FORTUNE, 541 N. Fairbanks Court, Chicago, IL 60611-3333.

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THE BEST FUNDS OVER THE PAST FIVE YEARS

The surest bets are the ones that score near the top year in and year out. ■ by Terence Paré

THE FIRST THING, and often the only thing, many investors look at when selecting a mutual fund is total return—dividends plus capital gains—over the past year or five years. But total return is just the first of several criteria investors should take into account. The level of risk and consistency of returns are as important as a high rate of return over any single period. After all, most people do not buy mutual funds for excitement.

To find funds that provided a solid return year after year, FORTUNE called upon CDA Investment Technologies, an investment research firm in Silver Spring, Mary-

land. The 15 funds in the larger table below are the ones that did well most consistently among all stock funds over the past five years. They are ranked not by the highest rate of return over the five years, but by a statistical measure of which did best year in and year out. For the record, we also list the five funds that shined brightest—all of them gold—over the past 12 months.

A consistent rate of return is particularly desirable in today's heady market, for peace of mind if nothing else. Consistency also is important because it affects an investor's ability to pull out of a fund in good shape even in down years. It's all well and

good to comfort yourself in lean times with the reflection that a 30% loss may transmute to a 90% gain when the market recovers. But that comfort will turn cold if you need the money for an emergency.

A portfolio manager who piloted his fund to happy returns over each of the past five years has navigated treacherous waters. Norman Fosbach, president of the Institute for Econometric Research, observes that since 1982 the market has gone from being powered mainly by secondary issues like technology stocks to being driven by blue chips. If a fund manager spots such shifts and reacts shrewdly to them, it augurs well.

More than half the funds in the table did better than Standard & Poor's 500-stock index for the 12 months ended September 30, when it boomed up 43.4%. Six outperformed the S&P's 27.6% rate of return over five years. And all but one beat the market over the past ten years. The one that did not, Loomis-Sayles Mutual, outperformed the S&P the past three years in a row. With the exception of Fidelity Destiny, all 15 funds posted gains when the market as a whole was off during the most recent significant down period, from December 1980 through July 1982. **1**

THE 15 MOST CONSISTENT WINNERS OVER THE PAST FIVE YEARS

NAME	1-YEAR RATE OF RETURN to 9/30/87	5-YEAR AVERAGE RATE OF RETURN	10-YEAR AVERAGE RATE OF RETURN	MOST RECENT DOWN MARKET RATE OF RETURN ¹
Loomis-Sayles Capital ¹	52%	32%	29%	16%
New England Growth	56%	28%	27%	16%
Fidelity Magellan	40%	35%	36%	14%
American Capital	43%	23%	28%	22%
Lehman Capital	48%	28%	27%	5%
New England Retirement	46%	24%	21%	9%
Tudor Fund ¹	42%	26%	25%	5%
American Capital Comstock	45%	22%	23%	14%
Loomis-Sayles Mutual ¹	39%	25%	18%	7%
Enterprise Fund ¹	43%	25%	20%	4%
Putnam Vista Basic Income	41%	24%	22%	4%
Fidelity Destiny	46%	32%	25%	-0.1%
Phoenix Stock Fund	40%	28%	26%	2%
United Vanguard Fund	40%	24%	24%	8%
Washington Mutual Investors	32%	27%	20%	6%

¹Indicates no load. ²Covers the period from 11/30/80 to 7/31/82.

THE FIVE HOTTEST FUNDS OVER THE PAST 12 MONTHS

NAME	1-YEAR RATE OF RETURN
Van Eck Gold/Resources	122%
IDS Precious Metals	115%
USAA Gold Fund ¹	109%
Keystone Precious Metals	101%
U. S. New Prospector Fund	97%

The five mutual funds that scored the biggest gains over the past 12 months all were up more than twice as much as the market as a whole. And all five are funds that specialize in precious metals. The prices of gold, silver, and platinum soared over the past year, driven upward by fears of higher inflation and interest rates. But the best and brightest of the mutual funds also are among the youngest of the breed. Among the top five, only Keystone Precious Metals has been around as long as five years. Its annual rate of return over that longer period—a comparatively meager 19%—was well below the S&P 500-stock index.

A NEGLECTED CLUE TO PROFITS

Return on equity is a telling pointer to a company's future performance. It highlights stocks that may lead the pack. ■ by Andrew Evan Serwer

THE PHONE RINGS. It's your broker, and has he got a stock for you. "This company is *fantastic!*" he booms. "It has a high alpha factor, a low beta factor, and it makes the best darn radish puller you've ever seen!" Do yourself a favor. Tell him to cut the Greek and answer a simple question. What's the company's return on equity?

Often overlooked by ordinary investors and Wall Street professionals alike, return on equity, or ROE, is the amount that the company earns on its shareholders' equity. It is a measure of how profitable the business is and how expertly management puts shareholders' dollars to work. "It doesn't matter whether you're investing in a company or running one, return on equity is the single best way to measure how a business is doing," says Alan C. "Ace" Greenberg, chief executive of Bear Stearns, a New York City brokerage firm. To calculate ROE, get a copy of the company's annual report and divide net income by shareholders' equity. Often called net worth, shareholders' common-stock equity equals the company's assets minus its liabilities and preferred stock, and it's the same as book value.

Theoretically, companies with consistently high ROEs should outperform the market, and over time they will. But your return as an investor, which consists of stock-price appreciation plus dividends, will not necessarily match the company's return on equity. That's because the price of a company's stock rises and falls with the market's perception of the company's future performance. Also, ROE is based on book value, and even if the stock's total return exactly matched the company's ROE, you would have had to buy your shares at book value for your return as an investor to equal the company's return on equity. You are far more likely to pay a premium over book value for a stock with a high ROE, so

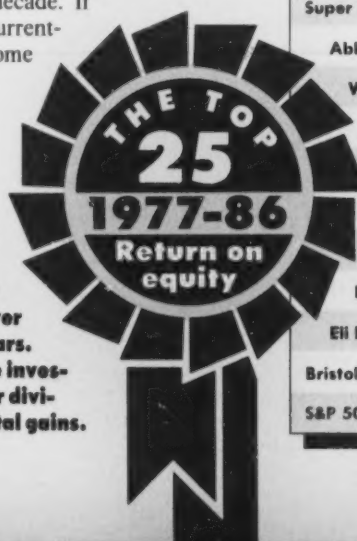
your return on *your* equity will probably be lower than the company's return on its.

That doesn't mean you can't catch up. The market will adjust your return by pushing the price of your stock up or down, depending on how sustainable investors perceive the company's superior performance to be. If, for example, enough investors believe that management can maintain or even improve a company's 20% return on equity, the stock should appreciate annually by that amount minus whatever is paid out in dividends.

The tricky part is figuring out how much you should pay to join the party. "Each investor must decide at what point the price for a given return becomes too great," says Steven Einhorn, co-chairman of the investment committee at Goldman Sachs. "Return on equity is a good place to start, but you must look at value also." How can you tell when the stock is too expensive?

There is no magic formula, but the market does drop clues. An important one is the stock's price-earnings ratio. Look in the Value Line and Standard & Poor's stock guides, available at your local library or at your broker's, for the stock's P/E range over the past decade. If the shares are currently trading at some

These 25 companies averaged an ROE of at least 20% over the past ten years. That often gave investors spectacular dividends and capital gains.



	Average annual ROE	Average annual total return
Commerce Clearing House	40.2%	28.1%
ServiceMaster	37.1%	26.4%
Subaru of America	33.7%	54.6%
Tandy	31.3%	23.3%
American Home Products	30.7%	14.8%
Kellogg	30.3%	20.3%
SmithKline Beckman	28.1%	21.2%
Dow Jones	26.6%	24.6%
Deluxe Check Printers	26.0%	31.8%
United States Tobacco	25.3%	24.1%
Wal-Mart Stores	25.0%	48.4%
EG&G	24.4%	22.7%
Dun & Bradstreet	24.2%	25.6%
General Cinema	24.1%	23.6%
Maytag	23.7%	17.8%
Super Valu Stores	23.2%	26.4%
Abbott Laboratories	22.6%	25.2%
Washington Post	22.5%	30.5%
Philip Morris	21.8%	21.2%
Coca-Cola	21.7%	16.9%
Melville	21.7%	19.5%
Merck	21.3%	17.3%
Nalco Chemical	20.8%	9.4%
Eli Lilly	20.5%	16.5%
Bristol-Myers	20.3%	28.3%
S&P 500	12.8%	14.2%

INVESTMENT STRATEGY AND VEHICLES

multiple of earnings that is higher than ever and far above the P/Es for other stocks in the same industry, you could be paying too much. Are investors willing to pay some exorbitant multiple of book value to own the company? If the ratio looks overly inflated by historical standards, most likely the price of the stock fully reflects the company's stellar ROE.

Finding value in a stock with a high ROE often means figuring out if those bountiful returns are sustainable. If you think so and the market doesn't—and you are right—the stock offers value. Here you have to start playing security analyst. Dig through annual reports and read the stock guides for tip-offs. Are sales and earnings growing? Is the

There are a few tricks that companies can pull to raise their ROE artificially, but you can usually spot them on the balance sheet or the income statement. Look to see if long-term debt is growing as a percent of total capital. By decreasing its equity through a repurchase of shares or by increasing its borrowing through sales of debt securities, a company can often jack up its ROE quickly. Borrowing is not bad, but it does make the company a riskier investment. If earnings tumble, managers may be forced to sell assets to service the debt, which will result in a lower ROE.

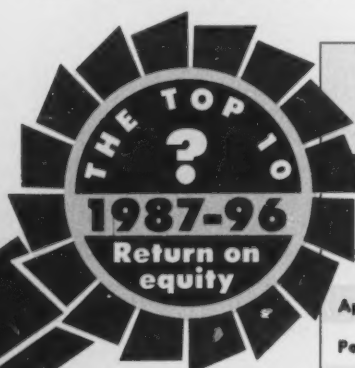
Be chary of one-time gains and nonrecurring items that temporarily inflate net income and thus return on equity. Unload-

culled the 500 largest industrial companies and the 500 largest service companies to find those that averaged a return on equity of at least 20%—a standard of excellence Wall Street analysts use—over the ten years ended in 1986. At no time could a company fall below 15%. Only 25 concerns made the cut; with one exception, Nalco Chemical, all were good to top-notch performers in the market. The group averaged an annual return to investors of 24.7% over the decade, shooting ahead of Standard & Poor's 500-stock index by ten percentage points.

The companies on the list have a lot of things in common. They are cost-conscious and believe in sticking to their core businesses. But most critical is their competitive position in their industry. Says Anne Anderson, president of Atlantis Investment Co., an advisory firm in Hoboken, New Jersey: "For a company to maintain an ROE of 20% or better for an extended period, there must be something unique about its business. It might be a brand name, a franchise, a patent. *Something* gives these companies a competitive edge." Good examples are the patented drugs of pharmaceutical companies like Merck, SmithKline Beckman, and Eli Lilly, the near-monopoly newspapers of Dow Jones and Washington Post Co., and the strong brand names of Kellogg, Coca-Cola, and Maytag.

EVEN SO, total return and return on equity don't match because of that varying perception by the market of the companies' ability to maintain high levels of profitability. For instance, Subaru of America, which imports cars to the U.S., returned a fat 54.6% per year to investors—after Tyson Foods, the second-best performance of America's 1,000 largest public companies. But Nalco, a producer of specialty chemicals, was the only company of the 25 to lag behind the market, returning a meager average of 9.4% annually.

If you bought Subaru in 1977, you paid only a slight premium over book value, which suggested the market was skeptical about Subaru's future. In 1986, however, Subaru's shares traded for more than six times their book value. You paid at least three times book value for Nalco in 1977, but investors never believed it could sustain its ROE in the unglamorous chemical business. Through the decade its shares hovered near three times book value. Now Subaru's return on equity has been pinched by the high yen and an overly aggressive buyer incentive program. Since last year the



Analysts think these ten companies will raise their ROE and sustain it for the next decade. Most have little long-term debt and are highly profitable.

	Last 3 years average annual ROE	Projected current- year ROE	P/E	Long-term debt to equity ratio
Limited	32.9%	38.0%	27.2	0.10
Bandag	29.3%	35.0%	18.2	0.21
Marion Labs	27.3%	28.0%	50.8	no LTD
Apple Computer	15.7%	25.5%	39.7	no LTD
PepsiCo	21.1%	25.3%	22.4	1.24
Squibb	19.8%	23.3%	23.5	0.05
Safety-Kleen	21.0%	22.5%	36.7	0.14
McKesson	17.3%	22.0%	17.9	0.54
Noxell	21.3%	22.0%	25.7	no LTD
Great Lakes Chemical	15.9%	21.1%	26.7	0.22

company generating a substantial cash flow? Does it have a well-established brand-name product or market leadership to keep those profits coming?

One sign that a company with a high ROE will be able to maintain it can be found in its payout ratio—that is, how much of its earnings it parcels out to investors as dividends. Look for a low ratio, because that means the company is reinvesting profits in its high-return businesses instead of frittering them away on the shareholders. Investors may prefer a fat dividend check, particularly since the demise of the capital gains preference puts dividends on equal tax footing with long-term gains starting in 1988. But a company with a high ROE is reinvesting its earnings at a top dollar rate. Could the shareholders invest those earnings as advantageously themselves?

ing the radish-puller division may produce an extraordinary gain, but only for one year. In 1987 many nonindustrial companies will get a one-time gain in the guise of a lower tax rate that will increase net income. Another point to remember: Cyclical businesses often produce cyclical returns on equity. USG, the largest domestic manufacturer of gypsum, dramatically improved its ROE from 6.2% in 1982 to 38.5% last year. A five-year boom in housing construction drove gypsum prices to record highs, but analysts don't expect those prices to hold up. So they think USG's return on equity may spring a few leaks in the basement.

Assuming you have not overpaid for a firm with a superior ROE, how well can you expect the stock to perform in terms of total return? To answer that question, FORTUNE

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MF01

INVESTMENT STRATEGY

No matter how high their ROEs, even rock-solid companies can become so overvalued they have nowhere to go but down.

stock has declined from \$39 to near \$10.

No matter how high their ROEs, even rock-solid companies like American Home Products, Coca-Cola, and Merck can become so overvalued that they have nowhere to go but down. In the early 1970s, during the so-called two-tier market, investors awarded these well-known growth stocks very high price-to-book multiples. But when the market soured in 1974, these stocks took a tremendous beating.

SPOTTING tomorrow's most profitable companies is not easy, but it can be very rewarding. For example, a \$20,000 investment in Subaru ten years ago was worth over \$1.5 million at the end of last year. The table on page 56 shows a sampling of companies that Wall Street analysts believe will average returns on equity of more than 20% for the next decade. Many of these enterprises have recently improved their ROEs, and all have something unique about their businesses that could well allow them to sustain a high return.

It's no surprise that two drug companies made the list, since patents can confer a potent competitive advantage. Analysts believe **Squibb** and **Marion Labs** will easily maintain ROE. "Squibb's is up because it bought back stock while its profits were rising sharply," says analyst Frederic Greenberg of Goldman Sachs. Squibb took that course because it believed the shares were undervalued and considered them a sound investment. Greenberg adds: "I think the company will become even more profitable over the next several years because its hypertension drug, Capoten, will be a strong seller into the 1990s."

Tom Nourse of Nourse Associates, an investment adviser in San Diego, notes that Marion Labs has a strong cash flow and no long-term debt. Profits rose nearly sevenfold from 1983 to 1987, while the dividend yield dropped from a lean 1.2% to a skimpy 0.5% because the company is reinvesting

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INVESTMENT STRATEGY

The Limited is "the leader of the specialty retailing business. The company gets more out of its floor space than any of its competitors."

its cash for growth and partly because the shares are more pricey. Unfortunately, at an amazing 16 times book value, Marion is an expensive stock. But if its past is prologue—the shares have gone up over sevenfold in the past 3½ years—the stock may be cheap at the price.

ALTHOUGH COMPANIES with high returns on equity most often crop up in the pharmaceutical and consumer product industries, Byron Wein, the U.S. portfolio strategist for Morgan Stanley, points out that savvy managers can make almost any business profitable. His example: the **Limited**. "It's an outstanding company, the leader of the specialty retailing business," he says. "It gets more out of its floor space than any of its competitors." Earnings have risen by a factor of 13 in the past decade, and the Limited has recently cut its long-term debt by over \$300 million.

Wein is also a fan of **McKesson**, the nation's largest distributor of drugs and toiletries. It owns 83.3% of Armor All, an upholstery and tire protector for cars. It sells several brands of bottled water in four Western states, and imports wine and liquor. Adds Wein: "McKesson owns 86.2% of PCS, which is the largest processor of prescription drug claims for group health plans in the nation and accounts for 9% of profits. It has little in the way of fixed costs, so its margins are high."

Both Coke and archrival **PepsiCo** are usually near the top of any profitability derby. Says analyst William Leach, of Donaldson Lufkin & Jenrette: "Look at how Pepsi's three major product groups are performing and you can see how strong the company is." The new Slice soft drink is adding fizz to soda sales, Frito-Lay is recovering from several off years, and the fast-food chains Taco Bell, Pizza Hut, and Kentucky Fried Chicken are really cooking.

Great Lakes Chemical makes specialty

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INVESTMENT STRATEGY

Companies in waste disposal and cleaning businesses are often highly profitable because the high cost of entry keeps out competitors.

chemicals used in fire retardants and water treatment. James Arenson of Donaldson Lufkin & Jenrette expects strong sales and earnings growth because its products are gaining market share. Return on equity should be back over 20% this year. Great Lakes has averaged a paltry dividend payout of 1.2% over the past ten years, and the company sells for about 3.5 times book value.

Charles Clough, chief portfolio strategist for Merrill Lynch, anticipates golden decades for two highly profitable companies. One is **Bandag**, which sells retreaded tires for trucks. "It dominates its market and should continue to do so," he says. "Bandag has always been very profitable. I think their ROE will hit over 30% again this year." **Apple Computer** is his other favorite. "Apple went through some tough times in 1984 and 1985, but adversity just made the company stronger," Clough says. He thinks the Macintosh computer will continue to be a strong seller.

Noxell averaged an ROE of 19.87% over the past decade without any long-term debt. Its ten-year average annual total return was almost 28%, and analysts feel confident that the cosmetics maker will do it again. Its Noxzema and Cover Girl lines continue to be the leading mass-market sellers. Profitability has improved steadily since 1982, and last year Noxell earned 21% on shareholders' equity.

COMPANIES in waste disposal and cleaning businesses are often highly profitable because of their specialized nature and because the high cost of entry keeps out competitors. Vishnu Swarup of Prudential-Bache likes **Safety-Kleen**, which leases devices with a solvent that cleans machinery parts for factories and service stations. "I think tougher enforcement of environmental laws will make Safety-Kleen's products more in demand," he says. "They dominate their business and they have very little debt."